

**FEDERAL ENERGY REGULATORY COMMISSION**

WASHINGTON, DC 20426

OFFICE OF THE CHAIRMAN

June 5, 2002

The Honorable John D. Dingell  
Ranking Member  
Committee on Energy and Commerce  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Congressman Dingell:

Thank you for your letter of May 21, 2002. In your letter, you urge the Commission to protect customers from unjust and unreasonable prices resulting from manipulative trading practices in wholesale power markets. You state that the Commission's response to the problems in California's energy markets in 2000-01 "was at best reactive, and at worst characterized by foot-dragging" and that the Commission's response to such problems continues to be untimely. You ask that the Commission not decide whether to terminate its existing mitigation of wholesale power prices in the West until the Commission understands the nature and effects of various trading practices. Similarly, you ask that the Commission defer action on any request to charge market-based prices in other parts of the country until completion of the Commission staff's current investigation. You also state that, if the Commission finds long-term power contracts executed last year in the West unjust and unreasonable due to the exercise of market power at their inception, the Commission must change the contracts despite any concern about loss of regulatory certainty.

Since I became Chairman in September 2001, the Commission has moved aggressively to protect the nation's energy customers by undertaking concrete steps to overhaul its market monitoring and enforcement functions, stepping up its non-public investigations into electric and natural gas market activities, and undertaking a number of generic rulemaking initiatives to develop market structures and market rules for the electric industry that will help prevent the exercise of market power and permit effective, ongoing market oversight. In addition, the agency is currently conducting a major, non-public investigation into potential market manipulation by Enron or any other entity in electric and natural gas markets in the West, since January 1, 2000. I anticipate presenting a report to Congress on this investigation this summer.

In addition, the Commission has undertaken the following initiatives to protect energy customers:

- **Office of Market Oversight and Investigation** - The Commission has appointed a director and continues to increase staffing for its new Office of Market Oversight and Investigation (OMOI). As soon as OMOI is fully staffed (as discussed in response to your question below), it will serve as a key interface to market monitoring units (MMUs) of Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs). OMOI will coordinate closely with the MMUs with respect to local and regional market patterns and problems, but will also look for patterns and problems across multiple regions and markets. OMOI will conduct monitoring and oversight and issue regular reports on the status of the nation's energy markets. It will also investigate possible market problems and participant misbehavior and recommend appropriate Commission responses (including enforcement actions and rule changes) to the problems it finds.
- **Regional Transmission Organizations (RTOs)** - The Commission continues to promote the development of properly structured and truly independent RTOs. RTOs will provide significant benefits to electric utility customers across the nation by eliminating obstacles to competition and enabling markets to operate more efficiently. By reducing bulk power prices and improving reliability, RTOs will benefit all electricity customers.
- **Revised Public Utility Filing Requirements** - The Commission recently issued a final rule (Order No. 2001) requiring detailed quarterly electronic reporting by power sellers (including marketers) of their power sales and transmission services. This new filing requirement will improve market transparency and information accessibility by making the data publicly available, leveraging current information technology for better data analysis, and by equalizing reporting requirements between traditional utilities and power marketers. The information revealed by the new quarterly reports should enhance public confidence in the fairness of the markets and make it easier to detect and discourage inappropriate practices in the energy markets.
- **Standard Market Design** - Through its ongoing rulemaking initiative on standard market design, the Commission intends to reform public utilities' open access tariffs to reflect a standardized wholesale market design. The new tariffs will eliminate inefficiencies caused by having different rules for different types of customers using the same transmission facilities, help ensure nondiscriminatory transmission services, and provide market participants with additional wholesale

power trading opportunities. The goals of this rulemaking initiative include providing improved services to all wholesale market participants; reducing delivered wholesale electricity prices through lower transaction costs and wider trade opportunities; reducing opportunities to game electricity markets; improving reliability through better grid operations and expedited infrastructure improvements; and increasing certainty about market rules and cost recovery for greater investor confidence to facilitate much-needed investment. A sound market design plays a critical role in reducing the incentives and opportunities to manipulate the markets.

In addition, I believe this rule should require transmission providers to have independent administration of the day-ahead and day-of energy markets (the markets in which market power is most likely to exist or be exercised) and also to have independent MMUs. The MMUs would monitor market conditions and market participant behavior, identifying circumstances they believe may warrant remedial actions or rule changes in order to ensure protection of electricity customers from possible market manipulations or market power abuse. In effect, the MMUs will be a front line of defense for monitoring short-term power markets, and will work with the Commission to anticipate, prevent and remedy market problems.

- **Infrastructure** - The Commission continues to promote adequate infrastructure by determining the rules for cost recovery of new energy infrastructure, encouraging the construction of new infrastructure, standardizing the rules for interconnecting new generating facilities, and licensing or certificating hydroelectric facilities and natural gas pipelines.

In sum, these initiatives are designed to improve the effectiveness of competitive wholesale markets and minimize or prevent the potential for market power abuse. In furtherance of these goals, the Commission and its staff will continue to work with other federal agencies and with the states to protect the nation's energy customers and achieve the full benefits of wholesale competition within jurisdictional markets.

Your letter asks about the Commission's upcoming decision on whether to continue the existing price mitigation in California and Western wholesale power markets. I assure you the Commission recognizes its legal obligation to ensure that rates in these markets are just and reasonable, and the affected customers are entitled to any regulatory protections needed to ensure such rates. While the Commission staff's investigation of manipulative trading practices may still be ongoing when the Commission needs to decide the price mitigation issue, the Commission will take into

account all market factors known at that time in determining what mitigation tools are appropriate under the circumstances. Once the investigation is completed, the Commission will determine any further steps that need to be taken.

You also ask that the Commission defer action on new applications for market-based rates. However, the Commission does not have authority under the Federal Power Act to defer action on such requests indefinitely. The Commission must act on such filings within 60 days (unless the applicant files more than 60 days before it proposes to begin selling power). While the Commission can suspend such filings for up to five months, the pendency of an investigation of trading behavior by other sellers cannot support such suspensions. However, the Commission will carefully scrutinize all requests for market-based rate applications. Further, if the Commission develops a record which demonstrates that a particular seller has exercised market power or engaged in inappropriate market practices, the Commission may revoke the seller's market-based rate authority.

You also address the long-term power contracts executed in Western markets last year. The Commission has instituted hearings on several complaints involving such contracts. Thus, I cannot address the merits of those cases. However, I fully agree with you that the Commission's ultimate rulings in those cases must be consistent with the Federal Power Act and the evidence submitted in those hearings.

Your letter also asks a number of specific questions regarding the Commission staff's investigation of manipulative trading practices and other issues. I am pleased to reply to these questions as follows. For your convenience, I have repeated your questions before providing an answer.

1. (a) What is the status of the Commission's new Office of Market Oversight and Investigation?

In January of this year, OMOI was established and in April I named William Hederman as the Director. Since coming on board, Mr. Hederman has been working closely with an "implementation team" to define the office's responsibilities, provide specific detail on the functions the office will perform, and finalize the structure of the organization. During June, Mr. Hederman will begin selecting people to fill the positions in OMOI, and many staff members already working elsewhere at the Commission will start being transferred into OMOI.

Notices have been posted seeking applicants for OMOI's two Deputy Director positions and those positions will be filled as soon as possible under the government's

hiring rules. By late August, most of the positions are expected to be filled and OMOI will be operational.

(b) How many staff currently are on board, and how many more do you need to hire?

OMOI will initially be staffed with about 100 people. Between half and three-quarters of the positions are expected to be filled by current Commission employees and the rest will be filled through recruiting from outside the agency. As indicated above, staffing is just beginning now.

(c) Did the Office of Management and Budget (OMB) provide the Commission with its full request? If not, what was the request to OMB?

The Commission requested and received approval from OMB for \$199.9 million and 1250 FTE's for FY 2003. This includes an increase of \$5 million and 50 FTE's specifically for the new Office of Market Oversight and Investigation.

(d) What is the status of the Commission's budget request and anticipated appropriations for this office for the balance of FY 2002 and FY 2003?

When fully staffed in FY 2003, the budget for the new office will be approximately \$15 million. This will include the \$5 million requested to fund the 50 new FTE's and \$10 million reallocated from other offices. The Commission has sufficient funding for the new office in FY 2002.

2. In your testimony of May 15, 2002, before the Senate Committee on Energy and Natural Resources, you stated that FERC "has contracted with leading experts in business and academia" to assist in the investigation of Enron and other companies that may have manipulated prices for electric energy or natural gas markets in the West since January 1, 2000.

Please provide the names of each consultant and describe the terms of his or her employment by the Commission. (a) Why was it necessary to engage outside consultants? (b) What precedent is there for this practice in prior Commission proceedings? (c) What steps have been taken to avoid conflicts of interests between such consultant's work for the Commission and any other activities in which they are engaged?

The names of the consultants are: Hendrik Bessembinder, Edward P. Kahn, Robert S. Pindyk, Chester S. Spatt, Michael J. Quinn and Aspen System Corporation. Additional information on these consultants is on the Commission's webpage at [www.ferc.gov](http://www.ferc.gov) under "Western Markets Investigation (Enron et al.)" (a) These consultants were retained by the Commission in order to provide assistance to the Commission staff as it goes forward in investigating the potential for manipulation of electric and natural gas markets in the Western United States. These consultants provide needed resources as well as specialized knowledge. (b) The Commission regularly engages consultants to provide assistance to its staff, in both docketed and non-docketed workload, as well as in administrative areas. For example, the Commission frequently has used third-party contractors in the preparation of environmental impact statements required under the National Environmental Protection Act. Because of the importance of the investigation into possible price manipulation of electric energy and natural gas markets in the West and the very specialized knowledge required to understand the operation of financial and physical markets for electric energy, the Commission has retained a greater number of outside experts than it has in many other instances. It also should be noted that, while the Commission can usually rely on outside expertise through filed, formal comments and parties' participation, given the nature and timeframe of this investigation, the Commission believes the use of outside consultants is the most efficient method for moving forward as quickly as possible. (c) It is standard practice for the Commission to require consultants to sign a Conflict of Interest Statement. Because of the sensitive nature of this investigation and the fact that some of the consultants have represented energy clients, the Commission took the further step of having attorneys in the Office of General Counsel's section on General and Administrative Law review these documents.

3. Please describe the nature of the Commission's coordination with the Securities and Exchange Commission and the Commodities Futures Trading Commission with respect to FERC's investigation of trading practices affecting wholesale power markets.

FERC's investigation of trading practices is focused in the first instance on identifying trading practices that should be prohibited, so that the Commission can take appropriate actions to prevent such conduct in the future. The investigation also will address whether the Commission should initiate formal enforcement actions or other remedial actions against specific market participants who may have violated their filed tariffs or Commission orders or regulations. The CFTC and SEC are conducting parallel investigations which may result in criminal and/or civil liability, both regarding corporate and individual conduct. We are in frequent contact with the SEC and CFTC and also are

coordinating with the U.S. Department of Justice. The agencies are sharing information and resources during the investigation.

4. In your May 15 Senate testimony, you state that you believe that "rules now in effect across the organized markets in the eastern markets prevent major manipulations of the type outlined in the Enron memos." (a) What is the basis for this conclusion? (b) Please describe the area comprising "eastern markets". (c) What about other areas of the country?

The strategies discussed in the Enron memoranda were mainly tailored to take advantage of two significant flaws in the California market design. First, the California market design did not fully consider transmission constraints in developing day-ahead schedules for energy. The market design considered transmission constraints between a northern California zone and a southern California zone. However, it did not consider potential transmission constraints within each of these zones. This allowed entities the opportunity to submit day-ahead schedules that were not physically feasible. Second, the California market design had a flawed system for addressing transmission congestion. (Congestion occurs when there is not sufficient transmission capacity to meet all requests.) Under the transmission congestion management system used in the California market design, entities with day-ahead schedules that were not physically feasible would then be paid in real time to change these schedules to relieve transmission congestion.

The eastern ISOs use a different market design that considers transmission constraints throughout their entire systems in developing day-ahead schedules for energy. Only day-ahead schedules that are physically feasible are accepted. Also, the "locational marginal pricing" system for transmission congestion management currently used in the mid-Atlantic region (PJM, which includes New Jersey, Pennsylvania, Delaware, District of Columbia, and Maryland) and New York (New York Independent System Operator), and soon to be adopted in New England (ISO-New England), assigns the cost of transmission congestion to the entities that cause the congestion. This congestion management system provides market participants with incentives to reduce congestion. Because of these differences, the market designs provide protection against most of the Enron strategies described in the memoranda.

A few of the strategies described in the Enron memos appear to depend on the marketer providing false information to the ISO. Thus, these strategies rely on evading or violating the market rules rather than market design flaws. For these types of strategies, the issue is ensuring appropriate monitoring capability and enforcement mechanisms to enforce the tariff. These types of strategies do not appear to have caused problems for the eastern ISOs.

5. Press reports of your May 15 Senate testimony indicate that you stated that, if the trading practices described in the Enron memoranda were not illegal, they should be. (a) If this accurately reflects your testimony, do you think these practices can be prevented by FERC henceforth under its current statutory authority? (b) By any other federal agency pursuant to its existing authority? If not, please describe the new authority you believe the Commission or other federal agencies may require to prevent such practices from recurring.

Based on my reading of the Enron memoranda, at this time I believe at least some of these trading practices should be prohibited. The Commission staff is investigating these practices closely, including the effects of each practice on energy prices and the possible encouragement of some of these practices by the California ISO. When the staff concludes its investigation, I will be better able to determine which of these practices should be prohibited. My preliminary view is that any of these trading practices deemed to adversely affect wholesale energy prices within the Commission's jurisdiction under the FPA could be prohibited under the Commission's existing statutory authority. However, I will be able to answer your question more definitively when the Commission staff concludes its investigation. As to new authority, I support an expansion of the penalty authority provided under the FPA, as a greater deterrent against market participants engaging in any trading practices prohibited under the FPA. I cannot speak to the authority of other federal agencies over these matters.

6. (a) Please describe all "round-trip" sales of electricity known to the Commission. For each such transaction, please list:
- (i) the name of the companies involved;
  - (ii) the amount of money involved;
  - (iii) the date of the sale; and
  - (iv) when the Commission became aware of the transaction.
- (b) Is the Commission confident that all such transactions have been reported to the Commission? If not, what steps are necessary to collect the information?
- (c) Does the Commission have data on round-trip sales only on western markets, or does it have data on all markets?
- (d) A Wall Street Journal article of May 16, 2000 states that "round-trip trades could also have been used to move prices in the wholesale market." Does the Commission have any evidence that the reported "round-trip" sales



have resulted in higher consumer prices in any markets? If the answer is yes, please be specific.

(e) Does the Commission believe the use of "round-trip" sales is prevalent in the industry, and does the Commission have any information concerning the motivation behind "round-trip" sales?

On May 21, 2002, Commission staff issued a data request to all sellers of wholesale electricity in the United States portion of the Western Systems Coordinating Council. The request was issued as part of the staff fact-finding investigation in Docket No. PA02-2-000. The request applies only to sellers in the West, as part of the staff investigation of market manipulation in that region. The request directs all sellers to respond under oath and admit or deny whether they engaged in "round-trip" trading and to provide relevant information including the companies involved, volumes, and prices. Sellers were also directed to indicate whether these transactions were reported to any organization that monitors, publishes, or reports trading data, prices, or forward indices. These responses were due on May 31, 2002.

The staff is beginning to analyze this data to determine whether "round-trip" transactions are prevalent and, in particular, to determine whether these financial transactions impacted the prices customers paid for electricity. Thus, it is not yet clear whether the "round-trip" sales were prevalent or have resulted in higher consumer prices in any markets. Nor is the motivation for these transactions clear, although various possible reasons have been reported in the media recently. The results of the investigation will be included in the staff's report to Congress.

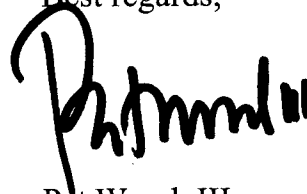
If sellers fail to respond fully, accurately and timely to the data request, the Commission will consider additional means of ensuring cooperation. For example, non-cooperation may warrant revocation of a seller's market-based rates.

The Honorable John D. Dingell

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If I can be of any further assistance to you, please feel free to contact me.

Best regards,

A handwritten signature in black ink, appearing to read "Pat Wood, III". The signature is stylized with a large initial "P" and a long, sweeping underline.

Pat Wood, III  
Chairman

cc: The Honorable W.J. "Billy" Tauzin, Chairman  
Committee on Energy and Commerce

The Honorable Joe Barton, Chairman  
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member  
Subcommittee on Energy and Air Quality